Internal Revenue Service

memorandum

CC:TL-N-9855-86
Br3:PSHorn

date: OCT 02 1986

to: District Counsel, New Orleans CC:NO
Attn: SEMoore

from: Director, Tax Litigation Division CC:TL

subject: [redacted]

This is in response to your request for technical advice dated September 18, 1986, regarding the following issue raised in the above-captioned case. This case has been the subject of previous technical advice on other issues arising therein.

ISSUE

Whether taxpayers' contributions to the Louisiana State Employees Retirement System ("LASER") are excludable from income under section 414(h). 0414.09-00

CONCLUSION

The contributions are not excludable from income under section 414(h) because the applicable State provisions implementing the requirements of section 414(h) were not effective for the year at issue.

FACTS

The facts in this case have been detailed in prior correspondence between our offices and are briefly repeated herein for ease of reference.

[redacted] was a Louisiana State [redacted] and a participant in LASER for years beginning after [redacted]. During [redacted] contributed $[redacted] to his retirement, an amount representing [redacted]% of his salary. He excluded this amount from income. In our previous technical advice we concluded that this amount could not be excluded from income under section 457 or section 252 of the Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA") as taxpayer claimed. This was because the employee contribution was made to the LASER trust exempt from taxation under section 401(a). That section had no applicable provision for the deduction or exclusion from income of such employee contributions. Since section 401(a) was controlling, the deferral provisions of section 457(a) did not allow taxpayers' exclusion.

You have indicated that taxpayers have filed a motion for leave to amend their petition in order to raise yet another alternative argument. This argument appears to be that if the employee contributions are not excludable under section 457(a) or section 252 of TEFRA, then such contributions are nonetheless excludable under section 414(h).

DISCUSSION

Section 414(h)(1) of the Code states that amounts contributed to a plan qualified under section 401(a), 403(a), or 405(a) may not, for tax purposes, be treated as employer contributions if they are designated as employee contributions.

Section 414(h)(2) provides an exception to this rule, however, by allowing contributions (otherwise designated as employee contributions) to government plans to be treated as employer contributions if the "employing unit picks up the contributions."

Taxpayers' alternative argument that section 414(h)(2) is applicable assumes that initially they were unable to show that the contributions were not made to a trust so as to allow for section 457 exclusion treatment. The applicable materials indicate that LASER did not adopt provisions implementing the requirements of section 414(h)(2) until 1984. As best we can determine, La. R.S. 42:697.12 added by Acts 1982, No. 843, sec. 1, effective August 4, 1982, provided that various state public retirement systems, including LASER, could adopt pick-up plans. Subsequently, La. R.S. 13:18, as amended by Acts 1983, No. 674. sec. 1, provided for the adoption by LASER of such a pick-up plan beginning in 1984.

Rev. Ruls. 81-35, 81-36, 1981-1 C.B. 255, state that section 414(h)(2) is only applicable if:

(1) the employer specifies that the designated employee contributions are being paid by the employer in lieu of contributions by the employee, and

(2) the employee does not have the option to receive the contributed amounts directly instead of having them paid to the pension plan.

See also Rev. Rul. 77-462, 1977-2 C.B. 358.

Under this type of arrangement, the state or local government, even if required to earmark a certain percentage of plan contributions as made by employees, is allowed pursuant to section 414(h)(2) to pick-up all or part of this employee contribution. The portion of the plan contribution picked-up is treated as an employer contribution for federal income tax purposes even though treated as an employee contribution under state law. As an employer contribution the amount is excludable from income until distributed under the rules of section 402.

The IRS ruled on August 28, 1983, that LASER met the requirements necessary for employee contributions to be picked-up pursuant to section 414(h)(2). Taxpayers allege that this formal adoption of the pick-up provisions represented no substantive change in the method by which employee contributions to LASER were previously handled. Therefore they claim that they should also be allowed to deduct the employee contributions for [redacted].

In Howell v. United States, 775 F.2d 887 (7th Cir. 1985), the court held that taxpayer, an Illinois State Court judge, could not exclude from income his employee retirement contributions for years prior to 1982. It was determined that it was not until years beginning in 1982 for which Illinois enacted legislation that provided for the pick-up of these employee contributions. Therefore in the absence of any indication that Illinois considered such amounts as picked-up for prior years, taxpayer was dependent on the state's designation regarding his tax treatment of such retirement plan contributions.

We agree that the analyses in Howell and Rev. Rul. 81-36 are controlling in this case. Since Louisiana did not by statute or other means manifest any intent to treat employee contributions as picked-up for years prior to 1984, [redacted]'s employee contributions are not excludable from income for [redacted] under section 414(h)(2).

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By: ______________________
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